APPEALS

COORDINATED ISSUE PROGRAM

SETTLEMENT GUIDELINES

INDUSTRY: All

ISSUE: Losses Claimed and Income to be Reported From Sale In/Lease Out (SILO) Transactions

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APPEALS SETTLEMENT GUIDELINE
ALL INDUSTRIES
LOSSES CLAIMED AND INCOME TO BE REPORTED FROM SALE IN/LEASE OUT (SILO) TRANSACTIONS
UIL 9300.38-00

ISSUES

Issue #1: Whether a taxpayer entering into a sale-leaseback transaction described in either of the situations detailed below (a "SILO") is entitled to deduct currently depreciation under § 168 of the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."), and to amortize transaction costs resulting from its participation in the transaction under § 162, or whether the taxpayer failed to acquire and retain "significant and genuine attributes" of a traditional owner, including "the benefits and burdens of ownership" of the property, for U.S. federal income tax purposes.[1]

Issue #2: Whether all or a portion of the Equity Investment (as hereafter defined) made by the taxpayer should be treated under the substance over form doctrine as a financing arrangement.

Issue #3: Whether a taxpayer entering into a SILO transaction is entitled to deduct interest expense resulting from its participation in the transaction under § 163, or whether the deductions are disallowed on grounds that no amount is paid for the use or forbearance of money.

Issue #4: Whether § 6662, the Accuracy-Related Penalty on Underpayments, § 6662A, the Accuracy-Related Penalty on Understatements with Respect to Reportable Transactions, or § 6707A, the Penalty for Failure to Include Reportable Transaction Information with the Return, apply to SILO transactions.

COMPLIANCE POSITION

On February 11, 2005, the Service notified taxpayers that it considered certain sale-leaseback transactions involving defeasance and lessees who were either tax-exempt or tax-indifferent to be tax avoidance transactions and identified SILOs and substantially similar transactions as listed transactions for purposes of Treas. Reg. § 1.6011-4(b)(2). See I.R.S. Notice 2005-13, 2005-1 C.B. 630 (Feb. 28, 2005). A Coordinated Issue Paper ("CIP") dealing with SILOs was issued on June 29, 2005.[2] The CIP sets forth the following positions:

Issues #1 and #2: A taxpayer entering into a SILO transaction is not entitled to deduct currently depreciation under § 168, or generally to amortize transaction costs resulting

[1] Section references are to the Code unless otherwise specified.
[2] The CIP can be reviewed by visiting the IRS Website at:
http://www.irs.gov/businesses/article/0,,id=140247,00.html

from its participation in the transaction under § 162, because such taxpayer does not acquire and retain "significant and genuine attributes" of a traditional owner, including "the benefits and burdens of ownership" of the property for U.S. federal income tax purposes. For the same reason, the taxpayer is not required to report rental income attributable to the transaction. This is a substance over form argument, under which a portion of taxpayer's equity investment is recharacterized as a loan to the tax-exempt party. The taxpayer will have original issue discount ("OID") income as a result of the deemed loan.[3]

Issue #3: A taxpayer entering into a SILO transaction is not entitled to deduct interest expense resulting from its participation in the transaction under § 163, as no amount is paid for the use or forbearance of money.

Issue #4: The accuracy-related penalty under § 6662 should not be asserted against a taxpayer entering into a SILO transaction if the taxpayer is able to establish reasonable cause and good faith under § 6664(c)(1) and the applicable regulations. For tax years ending after October 22, 2004, the accuracy-related penalty under § 6662A should not be asserted against a taxpayer entering into a SILO transaction if the taxpayer is able to establish reasonable cause and good faith under § 6664(d). If the taxpayer is unable to establish reasonable cause and good faith, the accuracy-related penalty should be asserted under § 6662 or 6662A if the facts and circumstances support the assertion of the penalty.[4]

TAXPAYER POSITION

Taxpayers generally argue that a SILO should be respected for federal income tax purposes, because: (1) SILOs have significant pre-tax profit; (2) SILO lessors acquire the benefits and burdens of ownership, regardless of collateralizing the rental obligations and, (3) the Service has not adequately addressed all the relevant elements that are normally associated with SILOs. For example, taxpayers argue that there are many more elements of risk to the lessor in a SILO than just the nonpayment of rent,

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[3] Although Notice 2005-13 and the CIP do not include a direct reference to an additional separate income adjustment due to the OID rules of §§ 1271–1275, the CIP states the taxpayer "can be viewed as the lender in a financing transaction involving a portion of the Equity Investment." Moreover, the OID issue has been raised expressly as part of the Government's primary position in the "Industry Directive on Treatment of Original Issue Discount Income, the Accommodation Fee, and Transaction Costs in Sale-In/Sale-Out Transactions" that was issued on September 8, 2005.

[4] The CIP concludes that § 6707A, the Penalty for Failure to Include Reportable Transaction Information with the Return, applies to SILO transactions. However, Compliance subsequently concluded that guidelines dealing with the administration of § 6707A need to be finalized before discussing the application of the § 6707A penalty to SILO transactions. If necessary, these Settlement Guidelines will be supplemented when issues of administration of § 6707A are resolved. The American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (the "AJCA"), which added the § 6662A accuracy-related penalty for understatements with respect to reportable transactions, also added § 6707A, a penalty for failing to make timely disclosures required under I.R.C. § 6011 (including undisclosed listed transactions). § 6707A applies to returns or statements the due date for which falls after the effective date of the AJCA (October 22, 2004) and which were not filed before that date.

such as the risks associated with the asset itself or its operation, or credit risks with the lessees, insurance providers or the collateral used in the transaction.

Specifically, taxpayers argue that the collateral taken by a lessor to legitimately mitigate lessee credit risk should not be determinative of the lessor's tax treatment of the transaction. They further argue that a SILO lessee is not compelled to exercise the purchase option over its other options and, consequently, the lessor will meet the benefits and burdens test applied by the courts to determine whether a lessor should be treated as the owner of leased property for federal income tax purposes. Taxpayers believe that SILO lessors will meet the following factors previously cited by the courts as indicative of a true sale and lease:

(1) existence of a useful life in excess of the basic lease term (the useful life of SILO property is more than the basic term of the respective lease);
(2) existence of a lessee purchase option price at or in excess of fair market value (according to an appraisal provided to taxpayer);
(3) renewal rental set to approximate fair market rate (according to the appraisal);
(4) reasonable possibility of recoupment of investment through income and residual value (the rental income from a SILO, when combined with the asset's residual value, always generates a predetermined after-tax rate of return);
(5) existence of a significant equity investment by the lessor (the initial equity investment typically made by SILO lessors (up to 20 percent) has been held to be sufficient);
(6) a significant residual interest at the end of the lease term (a SILO lessor retains a significant residual interest as determined by appraisal primarily because the useful life of SILO property is substantially more than the basic term of the respective lease);
(7) existence of a pre-tax profit (the rental income from a SILO combined with the residual value of the SILO asset always generates a predetermined pre-tax rate of return);
(8) existence of collateral (as previously noted, SILO rental obligations are collateralized);
(9) possession and use by the lessor (a SILO lessor may acquire use of the property at the end of the base term of the lease); and,
(10) facility user's purchase option (SILO option prices are not bargain options or unreasonably low, as determined by appraisal).[5]

[5] Taxpayers cite a number of legal opinions to support their position on the above factors. For example, the first five factors cited were utilized in Torres v. Comm'r, 88 T.C. 702 (1987), to determine whether: (1) there was a true lease and (2) the lessor acquired the burdens and benefits of ownership. The fifth and sixth factors above were cited in Larsen v. Comm'r, 89 T.C. 1229, 1266 (1987), aff'd in part and rev'd in part, sub nom Casebeer v. Comm'r, 909 F.2d 1360 (9th Cir. 1990), and Thomas v. Comm'r, 84 T.C. 412 (1985), to uphold valid leases.

DISCUSSION

BACKGROUND

SILOs utilize sale-leaseback arrangements with debt and equity defeasances[6] and have been marketed since the early 1990s as a way to avoid the restrictive tax-exempt entity leasing rules of § 168(h), which require depreciation over the life of the asset as measured by the lease term, including the term of any renewal lease. The leasing industry has also employed lease in/lease outs ("LILOs") to avoid application of § 168(h).

The earliest SILOs were known as Replacement Lessee Pickle leases. On April 29, 1996, final regulations were issued under § 168 requiring that the basic lease term and the term of any lease with a replacement lessee be aggregated in determining the depreciation recovery period.[7]

LILOs followed. With LILOs, the use of a head lease for a period less than the useful life of an asset allowed taxpayers to claim rent deductions, subject to the limitations of § 467. The Service addressed LILO tax shelters by issuing Rev. Rul. 99-14, 1999-1 C.B. 835, final § 467 regulations (effective May 18, 1999) and Rev. Rul. 2002-69, 2002-2 C.B. 760, the latter of which relied primarily on the doctrine of substance over form to hold that taxpayers involved in LILOs do not acquire a current leasehold interest and, therefore, are not entitled to current deductions for rent and interest. The issuance of the aforementioned final regulations and of Rev. Rul. 99-14 effectively stopped further taxpayer transactions involving LILOs.[8] When the § 467 regulations were finalized in May 1999, making the write-offs less attractive (§ 467 requires, among other things, the use of the proportional method and present value concepts to determine rent deductions), the industry switched back to SILOs except that, instead of a replacement lease, taxpayers began to use a "service contract" or, in the case of qualified technological equipment ("QTE"), residual value insurance in order to ensure a minimum return.[9]

Taxpayers substituted a service agreement for a replacement lease in order to claim a shorter depreciation recovery period. Whereas the term of a replacement lease must be added to the primary lease term when determining the recovery period of tax-exempt use property (under § 168(g)(3)(A), the recovery period is no less than 125 percent of the aggregate lease term), the period of a true service contract can be ignored for this purpose. Taxpayers used QTE because of the special recovery period applicable to such property under § 168(g)(3)(C), i.e., five years for hardware. Furthermore, the cost of QTE software is amortized over a three-year period under § 167(f)(1)(A).

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[6] As used herein, the term "defeasance" refers to an arrangement that, from an economic perspective, renders a payment obligation null and void inasmuch as funds sufficient to satisfy the obligation have been set aside for that purpose.
[7] Treas. Reg. § 1.168(i)-2(b)(1). The respective proposed regulations were issued in April 1995.
[8] LILOs are a Compliance Coordinated Issue, and Appeals Settlement Guidelines were issued on February 23, 2004, to address losses and income reported from LILO transactions (UIL 9300.07-00).
[9] QTE is defined by § 168(i)(2).

Testifying before the Senate Budget Committee on February 13, 2004, Treasury Secretary John Snow said that even though domestic SILO transactions raise money for local governments, they must be curtailed:

> There's something just fundamentally wrong about this [a SILO] and it needs to be stopped. This is a real bad deal for the taxpayers of the United States of America.

Bud Newman, Tax Shelters: Snow Says Use of SILO Transactions to Avoid Taxes Needs to be Stopped, Daily Tax Rep. (BNA), Feb.17, 2004.

As noted above, the AJCA was enacted on October 22, 2004. Section 848 of the AJCA added new § 470, which suspends losses for certain leases of property to tax-exempt entities, and is generally effective for leases entered into after March 12, 2004. This legislation effectively terminated use of SILOs.

To summarize, SILO transactions are very similar to LILO transactions in both form and structure. In a LILO, the transaction is structured as a lease-leaseback. The head lease is for a period shorter than the useful life of the asset. Therefore, the transaction does not purport to involve a sale of property. In a SILO, the transaction is a purported sale-leaseback, where either legal title to the property changes hands or the length of the head lease, including options to renew, exceeds the useful life of the asset. Therefore, the transaction purports to involve a sale of the property for federal income tax purposes. If a transaction is not substantially defeased, it is not considered a transaction covered by the listing notices for SILO or LILO transactions (although the Service may still be able to raise other legal arguments to challenge tax benefits claimed in connection with the transaction).

FACTS[10]

Described below are transactions in which a U.S. taxpayer ("X") enters into a purported sale-leaseback transaction with a tax-exempt entity ("FP"), substantially all of whose payment obligations are economically defeased. BK1, BK2, BK3, and BK4 are banks. None of these parties is related to any other party, unless otherwise indicated.

Situation 1

On the closing date of January 1, 2003 ("Closing Date"), X and FP enter into a purported sale-leaseback transaction under which FP sells the property to X, and X immediately leases the property back to FP under a lease ("Lease"). The purchase and sale agreement and Lease are nominally separate legal documents. Both agreements,

[10] For purposes of these Settlement Guidelines, the use of terms such as "loan," "lease," "head lease," "sublease," "lessor" and "lessee" is for convenience only and no inference is intended as to the proper tax characterization of the SILO transactions described herein.

however, are executed pursuant to a comprehensive participation agreement ("Participation Agreement"), which provides that the parties' rights and obligations under any of the agreements are not enforceable before the execution of all transaction documents.

The Lease requires FP to make rental payments over the term of the Lease ("Lease Term"). As described below, the Lease also provides that under certain conditions, X has the option ("Service Contract Option") to require FP to identify a party ("Service Recipient") willing to enter into a contract with X to receive services provided using the leased property ("Service Contract") that commences immediately after the expiration of the Lease Term. The Service Recipient must meet certain financial qualifications, including credit rating and net capital requirements, and provide defeasance or other credit support to satisfy certain of its obligations under the Service Contract. If FP cannot locate a qualified third party to enter into the Service Contract, FP or an affiliate of FP must enter into the Service Contract. The aggregate of the Lease Term plus the term of the Service Contract ("Service Contract Term") is less than 80 percent of the assumed remaining useful life of the property.[11]

On Closing Date, the property has a purported fair market value of $105x and X makes a single payment of $105x to FP. To fund the $105x payment, X provides $15x in equity and borrows $81x from BK1 and $9x from BK2. Both loans are nonrecourse and provide for payments during the Lease Term. Accrued but unpaid interest is capitalized as additional principal. As of the Closing Date, the documents reflect that the sum of the outstanding principal on the loans at any given time will be less than the projected fair market value of the property at that time. The amount and timing of the debt service payments equal or closely match the amount and timing of the Lease payments due during the Lease Term.

FP intends to utilize only a small portion of the proceeds of the purported sale-leaseback for operational expenses or to finance or refinance the acquisition of new assets. Upon receiving the $105x purchase price payment, FP sets aside substantially all of the $105x to satisfy its lease obligations. FP deposits $81x with BK3 and $9x with BK4. BK3 usually is related to BK1, and BK4 usually is related to BK2. The deposits with BK3 and BK4 earn interest sufficient to fund FP's rent obligations as described below. BK3 pays annual amounts equal to 90 percent of FP's annual rent obligation under the Lease (that is, amounts sufficient to satisfy X's debt service obligation to BK1). Although FP directs BK3 to pay those amounts to BK1, the parties treat these amounts as having been paid from BK3 to FP, then from FP to X as rental payments, and finally from X to BK1 as debt service payments. In addition, FP pledges the deposit with BK3 to X as security for FP's obligations under the Lease, while X, in turn, pledges its interest in FP's pledge to BK1 as security for X's obligations under the loan from BK1. Similarly, BK4 pays annual amounts equal to 10 percent of FP's rent obligation under the Lease (that is, amounts sufficient to satisfy X's debt service obligation to

[11] As previously noted, earlier transactions might provide for a "replacement lease" rather than a Service Contract. In these transactions, FP can be obligated to secure a replacement lessee for a renewal lease term.

BK2). Although FP directs BK4 to pay these amounts to BK2, the parties treat these amounts as having been paid from BK4 to FP, then from FP to X as rental payments, and finally from X to BK2 as debt service payments.[12] Although FP's deposit with BK4 is not pledged, the parties expect that the amounts deposited with BK4 will remain available to pay the remaining 10 percent of FP's annual rent obligation under the Lease. FP may incur economic costs, such as an early withdrawal penalty, in accessing the BK4 deposit for any purpose other than those contemplated by the interrelated arrangements.

FP is not legally released from its rent obligations. X's exposure to the risk that FP will not make the rent payments, however, is substantially limited by the arrangements with BK3 and BK4. In the case of the loan from BK1, X's economic risk is remote due to the deposit arrangement with BK3. In the case of the loan from BK2, X's economic risk is substantially reduced through the deposit arrangement with BK4. X's obligation to make debt service payments on the loans from BK1 and BK2 is completely offset by X's right to receive Lease rentals from FP. As a result, neither bank bears a significant risk of nonpayment.[13]

FP has an option ("Purchase Option") to purchase the property from X on the last day of the Lease Term ("Exercise Date"). Exercise of the Purchase Option allows FP to repurchase the property for a fixed exercise price ("Exercise Price") that, on the Closing Date, exceeds the parties' projected fair market value of the property on the Exercise Date. The Purchase Option price is sufficient to repay X's entire loan balances and X's initial equity investment and provide X with a predetermined after-tax rate of return on its equity investment.

At the inception of the transaction, X requires FP to invest $9x of the $105x payment in highly rated debt securities ("Equity Collateral"), and to pledge the Equity Collateral to X to satisfy a portion of FP's obligations under the Lease.[14] Although the Equity Collateral is pledged to X, it is not among the items of collateral pledged to BK1 or BK2 in support of the nonrecourse loans to X. The Equity Collateral upon maturity, in some cases combined with the remaining balances of the deposits made with BK3 and BK4 and the interest on those deposits, fully funds the amount due if FP exercises the Purchase

[12] Transaction documents may direct FP to make rent payments directly to the lending institutions so long as the purported loans have unpaid balances.

[13] The arrangement by which FP sets aside the funds necessary to meet its obligations under the Lease may take a variety of forms other than a deposit arrangement involving BK3 and BK4. These arrangements include a loan by FP to X, BK1 or BK2; a letter of credit collateralized with cash or cash equivalents; a payment undertaking agreement; a sinking fund arrangement; a guaranteed investment contract; or financial guaranty insurance.
In some SILOs, FP prepays all or nearly all of its lease rent to the taxpayer, but the taxpayer defers inclusion of the amount as income, using present-value concepts, under § 467. This prepayment could be made on the Closing Date, removing the need for third-party financing and traditional debt defeasance accounts, or it could be made later on during the Lease Term.

[14] The arrangement by which the return of X's equity investment plus a predetermined after-tax return on such investment is provided may take a variety of forms other than an investment by FP in highly-rated debt securities. For example, FP may be required to obtain a payment undertaking agreement from an entity having a specified minimum credit rating.

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Option. This arrangement ensures that FP is able to make the payment under the Purchase Option without an independent source of funds. Having economically defeased both its rental obligations under the Lease and its payment obligations under the Purchase Option, FP keeps, as its fee for engaging in the transaction, the remaining $6x, subject to its obligation to pay the Termination Value (described below) upon the happening of certain events specified under the Lease.

If FP does not exercise the Purchase Option, X may elect to (1) take back the property, or (2) exercise the Service Contract Option and compel FP either to (a) identify a qualified Service Recipient, or (b) enter (or compel an affiliate of FP to enter) into the Service Contract as the Service Recipient for the Service Contract Term. If X exercises the Service Contract Option, the Service Recipient must pay X predetermined minimum capacity payments sufficient to provide X with a minimum after-tax rate of return on its equity investment. The Service Recipient also must reimburse X for X's operating and maintenance costs for providing the services.

As a practical matter, the Purchase Option and the Service Contract Option collar X's exposure to changes in the value of the property. If the value of the property is at least equal to the Purchase Option Exercise Price, FP likely will exercise the Purchase Option. Likewise, FP likely will exercise the Purchase Option if FP concludes that the costs of the Service Contract Option exceed the costs of the Purchase Option. Moreover, FP may exercise the Purchase Option even if the fair market value of the property is less than the Exercise Price because the Purchase Option is fully funded, and the excess of the Exercise Price over the projected value may not fully reflect the costs to FP of modifying, interrupting, or relocating its operations. If the Purchase Option is exercised, X will recover its equity investment plus a predetermined after-tax rate of return. Conversely, if the Purchase Option is not exercised, X may compel FP to locate a Service Recipient to enter into the Service Contract in return for payments sufficient to provide X with a minimum after-tax rate of return on its equity investment, regardless of the value of the property.

Throughout the Lease Term, X has several remedies in the event of a default by FP, including a right to (1) take possession of the property or (2) cause FP to pay X specified damages ("Termination Value"). Likewise, throughout the Service Contract Term, X has similar remedies in the event of a default by the Service Recipient. On Closing Date, the amount of the Termination Value is slightly greater than the purchase price of the property. The Termination Value fluctuates over the Lease Term and Service Contract Term, but at all times is sufficient to repay X's entire loan balances and X's initial equity investment plus a predetermined after-tax rate of return. The BK3 deposit, the BK4 deposit and the Equity Collateral are available to satisfy the Termination Value during the Lease Term. If the sum of the deposits plus the Equity Collateral is less than the Termination Value, X may require FP to maintain a letter of credit. During the Service Contract Term, the Service Recipient will be required to provide defeasance or other credit support that would be available to satisfy the Termination Value. As a result, X in almost all events will recover its investment plus a pre-tax rate of return.

For tax purposes, X claims deductions for interest on the loans, amortization of transaction costs, and depreciation on the property. X does not include the optional Service Contract Term in the Lease Term for purposes of calculating the property's recovery period under §§ 168(g)(3)(A) and 168(i)(3). X includes in gross income the rents received on the Lease. If the Purchase Option is exercised, X also includes the Exercise Price in calculating its gain or loss realized on disposition of the property. The form of the sale from FP to X may be a head lease for a term in excess of the assumed remaining useful life of the property and an option for X to purchase the property for a nominal amount at the conclusion of the head lease term. In some variations of this transaction, the Participation Agreement provides that if X refinances the nonrecourse loans, FP has a right to participate in the savings attributable to the reduced financing costs through renegotiation of certain terms of the transaction, including the Lease rents and the Exercise Price.

Situation 2

The facts are the same as in Situation 1 except for the following. The Lease does not provide a Service Contract Option. In lieu of the Purchase Option described in Situation 1, FP has an option (the "Early Termination Option" or "ETO") to purchase the property from X on some fixed date (e.g., 30 months) before the end of the Lease Term ("ETO Exercise Date"). Exercise of the Early Termination Option allows FP to terminate the Lease and repurchase the property for a fixed exercise price ("ETO Exercise Price") that on the Closing Date exceeds the projected fair market value of the property on the ETO Exercise Date. The Early Termination Option price is sufficient to repay X's entire loan balances and X's initial equity investment plus a predetermined after-tax rate of return on its equity investment. The balance of the Equity Collateral combined with the balance of the deposits made with BK3 and BK4 and the interest on those deposits fully fund the amount due under the Early Termination Option.[15]

If FP does not exercise the Early Termination Option, FP is required to obtain at its cost residual value insurance ("RVI") for the benefit of X, pay rents for the remaining Lease Term, and return the property to X at the end of the Lease Term ("Return Option"). The RVI must be issued by a third party having a specified minimum credit rating and must provide that if the actual residual value of the property is less than a fixed amount ("RVI Amount") at the end of the Lease Term, the insurer will pay X the shortfall. On the Closing Date, the RVI Amount is less than the projected fair market value of the property at the end of the Lease Term. If FP does not maintain the RVI coverage as required after the ETO Exercise Date, FP will default and be obligated to pay X the Termination Value. If FP does not exercise the Early Termination Option, the rents for the remaining Lease Term plus the RVI Amount are sufficient to provide X with a

[15] In some instances, the ETO amount is sufficient to repay FP rent that FP overpaid or prepaid during the initial lease term. In transaction documents, this amount may be referred to as the Excess of Basic Rent Payments over Basic Rent Allocations or Basic Rent Payments in Excess of Basic Rent Allocations. It is combined with the equity and loan balances to fund the ETO.

minimum after-tax rate of return on the property, regardless of the value of the property. As a practical matter, the Early Termination Option and the Return Option collar X's exposure to changes in the value of the property. At the end of the Lease Term, FP also may have the option to purchase the property for the greater of its fair market value or the RVI Amount.[16]

For tax purposes, X claims deductions for interest on the loans, amortization of transaction costs, and depreciation on the property. X treats a portion of the property as qualified technological equipment within the meaning of § 168(i)(2). X depreciates that portion of the property over five years under § 168(g)(3)(C). X treats a portion of the property as software. X depreciates that portion of the property over 36 months under § 167(f)(1)(A).

X includes in gross income the rents received on the Lease. If the Early Termination Option or the Purchase Option is exercised, X also includes the exercise price in calculating its gain realized on disposition of the property.[17] In some variations of this transaction, if the Early Termination Option is not exercised, the Lease rents payable to X may increase for the portion of the Lease Term remaining after the ETO Exercise Date.

LEGAL ANALYSIS

In BB&T Corp. v. United States, No. 1:04CV00941, 2007 WL 37798 (M.D.N.C. Jan. 4, 2007), a U.S. District Court judge for the Middle District of North Carolina ruled for the Government in the first and only LILO case to be resolved by a court as of the time of this writing. The court determined that the LILO did not involve a genuine lease or genuine indebtedness.[18] There are currently no statutes or cases that specifically address SILOs entered into prior to March 13, 2004 (the effective date of I.R.C. § 470). As noted, new § 470 is not retroactive; however, the legislative history indicates that Congress did not intend to alter or supplant the present-law tax rules providing that a taxpayer is treated as the owner of leased property only if the taxpayer acquires and retains significant and genuine attributes of an owner of the property. H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. at 660, 662-663 (2004). Consequently, substance over form concepts and other common law doctrines apply to SILO transactions entered into prior to March 13, 2004.

[16] In the event FP has not exercised its Early Termination Option, the Equity Collateral will be available to fund the Return Option, to the extent the funds have not been used to satisfy other Lease obligations, including rent. In general, following the ETO Exercise Date, FP will not have access to the Equity Collateral until the end of the Lease Term, and there will be either unpaid balances on the original third-party loans or new loans refinancing those balances.

[17] Some taxpayers apparently have entered into transactions designed to defer or exclude this gain. For example, one type of transaction involves a foreign corporation that acquires an option to purchase X's residual interest and a subsequent payment by X to the foreign corporation that is not considered subpart F income subject to current U.S. income taxation.

[18] The plaintiff in this case has filed an appeal with the Fourth Circuit Court of Appeals.

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Issues #1 and #2: The Benefits and Burdens of Ownership and Financing Arrangement Arguments

At issue is whether the substance of the SILO comports with its form. Consistent with published Service guidance, Compliance takes the position that there is no genuine sale because the taxpayer does not acquire and retain “significant and genuine attributes” of a traditional owner, including “the benefits and burdens of ownership” of the property for U.S. federal income tax purposes unless and until the lessee fails to exercise its Purchase Option and the taxpayer then exercises its option to obtain use of the property. Until that time, the taxpayer obtains at most a contingent future interest in the property. Consequently, the taxpayer is not entitled to deduct currently depreciation under § 168, or generally to amortize transaction costs during the taxable year in issue.

The U.S. Supreme Court has ruled that the substance of a transaction, not the form, governs the tax treatment. See Gregory v. Helvering, 293 U.S. 465, 470 (1935); Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978). In Frank Lyon, the Supreme Court established a practical approach for distinguishing sale-leasebacks from financing transactions by concluding that, as long as the lessor retains “significant and genuine attributes of the traditional lessor status,” the form of the transaction as a sale-leaseback will be recognized for tax purposes. 435 U.S. at 584.

In Frank Lyon, the Court concluded that it was the party whose risk capital was committed to the construction of the property at issue that should be permitted to claim depreciation for the consumption of that risk capital through depreciation. Id. at 581. The Court found that risk capital to include both the taxpayer’s equity contribution and the funds it obtained through recourse borrowing, both of which were fully expended in the construction of the property at issue. Had the value of the property declined, the taxpayer would have suffered the loss. As the taxpayer committed both equity and debt risk capital to the construction of the building, it was found to be its owner. Id.

Subsequently, courts have held the question of who bears the economic risk of loss through declines in market value to be central to the determination of tax ownership. In Swift Dodge v. Commissioner, 692 F.2d 651 (9th Cir. 1982), the issue before the court was whether the transactions in question (“open end” vehicle leases) constituted conditional sales or leases for federal income tax purposes. Finding that the transactions “shifted the risk of depreciable loss to the vehicle user” (through a contractual provision requiring the user to pay the taxpayer the amount by which a predetermined “depreciated value” exceeded the wholesale value of the vehicle), the court found the users to be the owners of the vehicles and the transactions to be conditional sales. Id. at 652. By contrast, where a taxpayer may either incur a loss or earn a profit arising from its investment in an interest in property, the taxpayer is treated as the owner of that interest. See Estate of Thomas v. Comm’r, 84 T.C. 412, 440 (1985) (taxpayer treated as the owner of computer equipment where the leases were closed-ended, the taxpayer bore the risk at the end of the leases that the residual value would not be sufficient to allow recoupment of the taxpayer’s cash outlay, and at the same time the taxpayer also possessed the potential for gain if residual values

exceeded the taxpayer’s investment).

In Kwiat v. Commissioner, T.C. Memo. 1992-433, the question was whether the transaction, cast in the form of a lease by the parties, should instead be treated as in substance a sale for federal income tax purposes. The court found that reciprocal put and call options in that case placed the risk and rewards of ownership, through increases or decreases in the value of the property, with the lessee. Id. Focusing on the collaring effect of the put and call options, the court in Kwiat stated:

> For the issue is not whether a commercial sale ultimately will be completed, but whether the transaction, as it stands at the time in question, sufficiently shifts the benefits and burdens of ownership such that the transaction should, for tax purposes, be treated as if it were a sale. The mere presence of reciprocal put and call options, exercisable within relatively short time periods, ultimately shifts substantial benefits and burdens of ownership. . . . Those benefits and burdens shift even if a sale is never consummated.

Id. at 334.

In the footnote accompanying that text, the court went on to note:

> Inasmuch as the “benefits and burdens of ownership” inquiry focuses primarily upon the *risk* of economic depreciation and the benefit of *possible* appreciation, it might aid the understanding to consider whether the ostensible lessor has retained the majority of the potential benefits and burdens of ownership.

Id. at 334 n.8 (emphasis added). See also Aderholt Specialty Co. v. Comm’r, T.C. Memo. 1985-491; Rev. Rul. 72-453, 1972-2 C.B. 87.

In a SILO, the effect of the Service Contract Option (RVI in the case of a QTE SILO) is to keep market risk (the risk of loss should property decline unexpectedly in value) with the tax-exempt entity. And the effect of the Purchase Option is to limit the U.S. taxpayer’s ability to profit from residual value. Under the foregoing precedents, these circumstances support Compliance’s position that the tax-exempt entity retains tax ownership of the property—i.e., there is no sale for federal income tax purposes, because market risk and the opportunity for market reward remain with the tax-exempt entity. Arguably, at most the U.S. taxpayer possesses a contingent future interest in the property as to which it claims depreciation. This interest is akin to the interest that the holder of an option to acquire property possesses prior to the exercise of that option.

In Williams v. Commissioner, 1 F. 3d 502 (7th Cir. 1993), aff’g, 94 T.C. No. 27 (1990), and Benedict v. United States, 881 F. Supp. 1532 (D. Utah 1995), the issue before the courts was whether the sellers of townhouses were entitled to claim installment sales treatment. The cases turned on when, in substance, the sales were deemed to occur

for tax purposes. While the homes were under construction, executed sales agreements, executed deeds and deposit checks were placed in escrow pending completion of construction and closing. The sales agreements provided that, in the event of a breach by the sellers, the buyers' sole remedy would be the return of their deposits plus interest. Reasoning that the buyers had neither possession nor the right to possess the homes before closing and noting that the sales agreements explicitly denied the buyers the right to force conveyance, the courts found that, for tax purposes, the sales of the homes did not occur until closing.

It is important to note that SILOs involve a different fact pattern from the sale-leaseback transaction respected by the Court in Frank Lyon. The substance over form doctrine and the factors cited by the Court in Frank Lyon support the conclusions that the purported lessor, i.e. the U.S. taxpayer, in a SILO: (1) does not acquire the benefits and burdens of ownership; (2) only acquires, at most, a contingent future interest in the property; and, consequently, (3) cannot claim the tax benefits as the owner of the property. The following important factors differentiate the facts that existed in Frank Lyon from the facts that are generally associated with SILOs:

1. The seller/lessee, i.e. the tax-exempt entity, in a SILO does not have access to most of the sales proceeds because it obligates itself to economically defease substantially all of its rent payment obligations and the amounts due under the Purchase Option (or the ETO in a QTE SILO) by establishing and pledging various deposits and/or arrangements with payment undertakers, i.e., the banks. In Frank Lyon, by contrast, the seller/lessee used the sales proceeds to construct a building under circumstances that caused the Court to conclude that the transaction was one "compelled or encouraged by business or regulatory realities."
2. The debt defeasances, pledges and security arrangements made on the lenders' behalf, seller/lessee's obligation for the Termination Value and the taxpayer's security interest in the Equity Collateral: (a) make the risk of rent non-payment remote and (b) do not leave the lessor at risk for repaying the loan balances or forfeiting its equity investment.[19] In Frank Lyon the taxpayer bore the risk of the lessee's nonpayment of rent, which could have forced the taxpayer to default on its recourse debt.
3. The lessor in a SILO bears insufficient risk of decline in the value of the property to be treated as its owner for tax purposes due to the Service Contract Option (or the RVI requirement in the case of a QTE SILO). In Frank Lyon, the return to the taxpayer was dependent on the property's value, and the taxpayer's equity investment was at risk if the property declined in value.
4. With SILOs, the seller/lessee's Purchase Option (the ETO in a QTE SILO) significantly limits the lessor's return if the value of the property exceeds the

[19] Indeed, when the nonrecourse lending is ignored, for the reasons set forth in the following section, the transaction is revealed to be a two-party transaction subject to the rules of Helvering v. Lazarus & Co., 308 U.S. 252 (1939)(legal title was not conveyed and there was no sale where a concurrently executed lease was really intended as an agreement to pay interest on a loan) and Sun Oil Co. v Comm'r, 562 F.2d 258 (3d Cir. 1977) (sale leasebacks of unimproved service station sites recharacterized as financings where a number of important features were employed to deprive the lessor of any significant ownership interest).

Exercise Price (the ETO Exercise Price in a QTE SILO). At the same time, the lessor's Service Contract Option under a Service Contract SILO and seller/lessee's continued rent and RVI obligations under the Return Option of a QTE SILO ensure a minimum return on the lessor's purported equity investment. These options also significantly increase the likelihood that the seller/lessee will exercise the Purchase Option or ETO with a Service Contract SILO or QTE SILO, respectively. In Frank Lyon, the lessee's exercise of its purchase option was not constrained by the lessor's right to exercise a reciprocal option. Moreover, with SILOs, the lessor's opportunity to recognize a return through refinancing the loans is also limited in those cases in which the seller/lessee has a right to participate in any savings attributable to reduced financing costs, such as through renegotiation of the lease rents and the Exercise Price.

5. Regulatory realities required or encouraged the transaction structure adopted by the parties in Frank Lyon. Such is not the case with the typical SILO.
6. SILOs create a federal tax deduction (depreciation) for the lessor that was not previously available to the seller/lessee due to its tax-exempt status. Neither party in Frank Lyon was a tax-exempt entity.
7. In most cases, the seller/lessee can exercise the Purchase Option at essentially no cost by paying over amounts (held by deposit takers and/or payment undertakers) that it would be required to pay over in any event at the lessor's direction, in the form of service contract fees.

The Supreme Court has long recognized that a sale subject to a lease and an option to repurchase may have the legal effect of creating a mortgage. See, e.g., Helvering v. Lazarus & Co., 308 U.S. 252 (1939); Frenzel v. Comm'r, T.C. Memo. 1963-276 (building constructed and sold at cost to institution under lease-option agreement). The Service has long held that the substance of a transaction is controlling for federal income tax purposes in situations involving the characterization of sale-leaseback transactions. See Rev. Rul. 72-543, 1972-2 C.B. 87 (concluding that a transaction in the form of a sale-leaseback is in fact a financing where, under the terms of the leaseback, the lessee never actually parted with the benefits and burdens of ownership of the property). Furthermore, to allow the true nature of a transaction to be disguised by mere formalisms, existing solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. The incidence of taxation depends on the substance of a transaction not its form, Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945), and the judicial test for determining if a transaction is a sale, as opposed to a lease or financing arrangement, is whether the benefits and burdens of ownership have passed to the purported purchaser, see, e.g., Frank Lyon, 435 U.S. at 573.

Whatever current substantive property rights a taxpayer obtains in a SILO relate not to the property, but to the amounts deposited as Equity Collateral. In most cases, the taxpayer is assured of being able to recover these amounts, together with the earnings thereon, in all events. If the tax-exempt entity exercises its buyout option, the amounts are returned to the taxpayer. In the event the tax-exempt entity does not exercise its buyout option, the taxpayer can compel repayment in the form of Service Contract fees.

In substance, the amounts deposited as Equity Collateral constitute loans by the taxpayer to the tax-exempt entity, with the investments acquired with those funds acting as security. See Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990), aff'g 857 F.2d 1161 (7th Cir. 1988), aff'g 88 T.C. 964 (1987)(customer deposits treated as deposits or loans rather than advance payments for services where preconditions to return of deposit were within the control of the customer); see also American Nat'l Bank v. United States, 421 F.2d 442 (5th Cir. 1970) (sale repurchase transactions recharacterized as secured loans where the taxpayer did not have the burdens and benefits of ownership); Union Planters National Bank v. United States, 426 F.2d 115 (6th Cir. 1970) (sale repurchase transactions recharacterized as secured loans where the economic substance of the transactions warranted such); and Nebraska Dep't of Revenue v. Lowenstein, 513 U.S. 123 (1994)(interest income from repurchase agreement involving federal securities did not qualify as interest on U.S. Government obligations for state income tax purposes where the federal securities were merely collateral for loans). Whatever current rights the taxpayer has to the property as a result of the SILO are as a lender to the tax-exempt entity, or as a secured party with respect to the investment assets purchased with the loan proceeds.

Accordingly, Compliance asserts, consistent with published Service position, that to the extent of the Equity Collateral, the transaction should be recast under the substance over form doctrine as a financing arrangement involving a loan of the Equity Collateral by the taxpayer to the lessee/tax-exempt entity. As a consequence, taxpayer has OID income. See I.R.C. §§ 1271 – 1275.

Issue #3: The § 163 Interest Expense Argument

Compliance asserts, consistent with published Service position, that no amount was paid for the use or forbearance of money. Consequently, the taxpayer should not be entitled to deduct interest expense.

Section 163 allows a deduction for all interest paid or accrued within the taxable year on indebtedness. The Code and case law generally define the term "interest" to mean the amount that one has contracted to pay for the use or forbearance of money. See, e.g., Old Colony R. Co. v. Comm'r, 284 U.S. 552 (1932); Deputy v. DuPont, 308 U.S. 488 (1940). However, all "borrowed" funds in SILO transactions are deposited in accounts with the banks (or payment undertakers) and are, therefore, unavailable to the taxpayer and the lessee/tax-exempt entity. Consequently, it can be argued that: (1) neither the taxpayer nor the tax-exempt entity obtain use of those "borrowed" funds; (2) the nonrecourse loans associated with SILOs have no substance; and, consequently, (3) SILO nonrecourse loans should be disregarded even though they allegedly finance the purchase price of the property.

In Bridges v. Commissioner, 39 T.C. 1064 (1963), aff'd, 325 F.2d 180 (4th Cir. 1963), the taxpayer "borrowed" funds from banks, used the funds to purchase Treasury notes (which the banks held as collateral), and ultimately sold these same notes to satisfy his

debts.[20] According to the court in Bridges, § 163 presupposes that, regardless of the resulting tax consequences, amounts paid as interest must have commercial reality, there must be some valid commercial reason for paying interest, and the borrower must in fact receive something in the transaction itself that would warrant payment of interest. Hence, to be deductible, the amounts paid must constitute interest and represent compensation for the use or forbearance of money. The Tax Court also noted, "[w]e doubt that the bank at any time actually had any of its money out on loan or that its portfolio of Treasury notes actually changed. The transaction merely provided the 'façade' of a loan." Id. at 1077.

Compliance points out the following factors, which support the conclusion that the interest expense associated with a SILO should be disallowed based on the aforementioned legal principles:

1. The nonrecourse loans lack substance since there is no meaningful credit risk to any party;
2. Neither the taxpayer nor the tax-exempt entity obtain use of the funds;
3. The purported loan does not enable the taxpayer to acquire the property, as taxpayer fails to acquire or retain the benefits and burdens of ownership of the property and, therefore, cannot be considered its owner for federal income tax purposes; and
4. The nonrecourse loans are to be paid with the rent due the taxpayer under the Lease, which lacks substance.

Issue #4: Penalties Under §§ 6662 and 6662A

Whether penalties apply as a result of a taxpayer's participation in a SILO transaction turns on the specific facts and circumstances of each case. Two accuracy-related penalties may apply to SILO transactions: (1) a general accuracy-related penalty under I.R.C. § 6662; or (2) an accuracy-related penalty for reportable transactions under I.R.C. § 6662A.

I. The General Accuracy-Related Penalty

As applicable to SILO transactions, I.R.C. § 6662 provides for a 20-percent accuracy-related penalty for an underpayment due to negligence or disregard of rules or regulations or a substantial understatement of income tax.

A. Negligence or Disregard of Rules or Regulations

The accuracy-related penalty for negligence may apply where a taxpayer has failed to make a reasonable effort to comply with the provisions of the Code or to exercise ordinary and reasonable care in the preparation of a tax return. See I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(1). Courts have held that negligence includes the "failure to

[20] The CIP cites Bridges as authority for disallowing the interest expense claimed to arise in SILO transactions.

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do what a reasonable and ordinarily prudent person would do under the circumstances." Marcello v. Comm'r, 380 F.2d 499, 506 (5th Cir. 1967); Neely v. Comm'r, 85 T.C. 934, 947 (1985).

There exists a strong indication of negligence where a taxpayer has failed to make a reasonable effort to determine whether a reported deduction, credit or exclusion was proper where it would appear "too good to be true" to a reasonable and prudent person under the circumstances. Treas. Reg. § 1.6662-3(b)(1)(ii). Courts have sustained the application of the negligence penalty in such instances. See, e.g., Neonatology Assocs. v. Comm'r, 299 F.3d 221, 234 (3d Cir. 2002) (warning that "[w]hen, as here, a taxpayer is presented with what would appear to be a fabulous opportunity to avoid tax obligations, he should recognize that he proceeds at his own peril"); Pasternak v. Comm'r, 990 F.2d 893, 903 (6th Cir. 1993); Sheldon v. Comm'r, 94 T.C. 738, 770 (1990) (stating that the taxpayer, "intentionally entered into loss-producing repos in order to generate and claim tax benefits").

A return position with a reasonable basis negates the existence of negligence. Treas. Reg. § 1.6662-3(b)(1). The regulations provide as follows: "[a] reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper." Treas. Reg. § 1.6662-3(b)(3). Thus, a taxpayer does not satisfy the reasonable basis standard with a merely arguable or colorable return position. Id. Conversely, under this subparagraph, a return position generally will have a reasonable basis where it is reasonably based on one or more of the authorities listed in Treas. Reg. § 1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authorities and subsequent developments, even if the position does not satisfy the substantial authority standard defined in Treas. Reg. § 1.6662-4(d)(2).

The accuracy-related penalty for disregard of the rules or regulations may apply where a taxpayer has disregarded the provisions of the Code, temporary or final regulations, and revenue rulings or IRS notices (aside from notices of proposed rulemaking) in a careless, reckless, or intentional manner. I.R.C. § 6662(c); Treas. Reg. § 1.6662-3(b)(2). A taxpayer disregards the rules or regulations in a "careless" manner by failing to exercise reasonable diligence in determining the correctness of a return position that is contrary to a rule or regulation. A taxpayer disregards the rules or regulations in a "reckless" manner by making little or no effort to determine whether a rule or regulation exists and deviating substantially from the standard of conduct a reasonable person would observe. A taxpayer disregards the rules or regulations in an "intentional" manner where the taxpayer has knowledge of the rule or regulation disregarded. Treas. Reg. § 1.6662-3(b)(2).

The accuracy-related penalty for disregard of rules or regulations will not apply to any portion of an underpayment due to a position contrary to rules or regulations if: (1) the taxpayer has disclosed the position on a properly completed Form 8275 or Form 8275-R (the latter is used for a position contrary to regulations) and (2) where a contrary regulation exists, the taxpayer challenges it in good faith. Treas. Reg. § 1.6662-3(c)(1) and (2). This exception applies only where the taxpayer has a reasonable basis for the

position and keeps adequate records to substantiate the position. Treas. Reg. § 1.6662-3(c)(1). With respect to a position contrary to a revenue ruling or a notice, a taxpayer has not disregarded the ruling or notice if the contrary position has a realistic possibility of a court or the IRS sustaining the position on its merits. Treas. Reg. § 1.6662-3(b)(2).

B. Substantial Understatement

The accuracy-related penalty for a substantial understatement may apply where the amount of an understatement for a taxable year exceeds the greater of 10 percent of the tax required to appear on the return or $5,000 ($10,000 in the case of corporations other than S corporations or personal holding companies). I.R.C. § 6662(d)(1).[21] An understatement generally means the excess of the correct tax over the tax reported on an income tax return. I.R.C. § 6662(d)(2). The computation of this excess does not include items to which I.R.C. § 6662A applies, as discussed below.[22]

In the case of items of corporate taxpayers attributable to tax shelters, I.R.C. § 6662(d) does not provide any grounds on which to reduce the understatement. I.R.C. § 6662(d)(2)(C)(ii) (as in force before amendment by the AJCA, October 22, 2004).[23] Therefore, if a corporate taxpayer has a substantial understatement attributable to a tax shelter item, the accuracy-related penalty applies to the understatement unless the reasonable cause and good faith exception applies.

C. Reasonable Cause Exception under the General Accuracy-related Penalty

The accuracy-related penalty does not apply with respect to any portion of an underpayment where the taxpayer acted with reasonable cause and in good faith regarding that portion. I.R.C. § 6664(c)(1). Whether a taxpayer acted with reasonable cause and in good faith turns on all pertinent facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). The determination should consider all relevant facts. The facts that should undergo development include the nature of the tax investment, the complexity of the tax issues, the independence of any tax advisors, the competence of any tax advisors, and the sophistication of the taxpayer. An especially important factor for consideration is the extent of the taxpayer's attempt to assess the proper tax liability. Id.; see also Larson v. Commissioner, T.C. Memo. 2002-295.

Reliance on the advice of a professional tax advisor does not necessarily suffice for a finding that the taxpayer acted with reasonable cause and in good faith. Treas. Reg. § 1.6664-4(b)(1). The advice must consider how the law relates to the pertinent facts

[21] The AJCA amended I.R.C. § 6662(d)(1)(B) for tax years beginning after October 22, 2004. Under § 6662(d)(1)(B), as amended, a corporation has a substantial understatement of income tax for the taxable year if the amount of the understatement exceeds the lesser of 10 percent of the tax required to be shown on the return (or, if greater, $10,000), or $10,000,000.

[22] Section 6662A applies only to tax years ending after October 22, 2004.

[23] This provision still applies to tax years ending on or before October 22, 2004. For tax years ending after October 22, 2004, no reduction is available for any item attributable to a tax shelter for both corporations and non-corporate taxpayers. I.R.C. § 6662(d)(2)(C).

and circumstances. Treas. Reg. § 1.6664-4(c)(1)(i). For example, the advice must consider the taxpayer's reason for a transaction and the reason for the transaction's structure. Id. A taxpayer has not reasonably relied in good faith on professional tax advice if the taxpayer failed to disclose a fact the taxpayer knew, or should have known, was relevant to the proper treatment of an item. Id.

The advice must not rely on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based on a representation or assumption that the taxpayer knows, or has reason to know, is most likely untrue, such as an inaccurate representation or assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner. Treas. Reg. § 1.6664-4(c)(1)(ii). Accordingly, it is necessary to evaluate the accuracy of critical assumptions contained in any opinion letter.

In any tax shelter transaction, the taxpayer has a duty to fully investigate all aspects of the transaction before proceeding. The taxpayer cannot simply rely on statements made to the taxpayer's advisor by another person, such as a promoter. See Novinger v. Comm'r, T.C. Memo. 1991-289. Moreover, if the tax advisor has little familiarity with the type of business in which the transaction takes place, mere reliance on the tax advisor does not suffice. See Addington v. United States, 205 F.3d 54, 58-59 (2d Cir. 2000); Goldman v. Comm'r, 39 F.3d 402, 408 (2d Cir. 1994); Collins v. Comm', 857 F.2d 1383, 1386 (9th Cir. 1988); Freytag v. Comm'r, 89 T.C. 849, 888 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd, 501 U.S. 868 (1991).

Reliance on tax advice does not entitle a taxpayer to a finding of reasonableness and good faith where the taxpayer knew, or should have known, that the advisor lacked familiarity with the relevant tax laws. Treas. Reg. § 1.6664-4(c)(1). The Tax Court has set forth a three-part test to determine whether a taxpayer's reliance on advice was sufficiently reasonable to negate the general accuracy-related penalty:

> (1) The advisor was a competent professional who had sufficient expertise to justify reliance;
>
> (2) The taxpayer gave to the advisor the necessary and accurate information; and
>
> (3) The taxpayer actually relied in good faith on the advisor's judgment.

Neonatology Assocs. v. Comm'r, 115 T.C. at 99.

An opinion letter prepared by a promoter or anyone else with a conflict of interest should not itself carry significant weight. Goldman, 39 F.3d at 408; Neonatology, 115 T.C. at 98; Marine v. Comm'r, 92 T.C. 958, 992-93 (1989), aff'd without published opinion, 921

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F.2d 280 (9th Cir. 1991). Thus, if a taxpayer did not itself have the requisite knowledge to assess the transaction and did not obtain a legal opinion from anyone other than the promoter in connection with its SILO transaction, the taxpayer's reliance on the legal opinion may not entitle the taxpayer to a finding of reasonableness. In addition, if the taxpayer did not receive the opinion letter until after the return was filed, he/she could not have reasonably relied on the opinion and thus, should not be relieved from penalties. See, e.g., Long Term Capital Holdings v. United States, 330 F. Supp. 2d 122, 207 (D. Conn. 2004), aff'd, 150 F. App'x 40 (2d Cir. 2005). It follows that, if a taxpayer is unwilling to produce a copy of an opinion letter upon which it allegedly relied, the taxpayer should not obtain relief from penalty consideration.

D. Stacking

There is no stacking of the accuracy-related components of I.R.C. § 6662. See Treas. Reg. § 1.6662-2(c). This means that the maximum accuracy-related penalty imposed on any portion of an underpayment is 20 percent (40% for gross valuation misstatements), even if that portion of the underpayment is attributable to more than one type of misconduct. See, e.g., DHL Corp. v. Comm'r, T.C. Memo. 1998-461, aff'd in part and rev'd on other grounds, 285 F.3d 1210 (9th Cir. 2002).

II. The Accuracy-Related Penalty for Reportable Transactions

The Service added SILO transactions to its list of "listed transactions" as defined in Treas. Reg. § 1.6011-4(b)(2) on February 11, 2005. See I.R.S. Notice 2005-13.[24] "Listed transactions" are reportable transactions under Treas. Reg. § 1.6011-4(b).

Section 6662A imposes an accuracy-related penalty in the amount of 20 percent of a reportable transaction understatement and applies to tax years ending after October 22, 2004.

In addition, a higher 30-percent penalty applies to a reportable transaction understatement if a taxpayer does not adequately disclose, in accordance with regulations prescribed under I.R.C. § 6011, the relevant facts affecting the tax treatment of the item giving rise to the reportable transaction understatement.

A. The Interaction of the Accuracy-Related Penalty for Reportable Transactions and the General Accuracy-Related Penalty

For purposes of determining whether a substantial understatement of income tax exists under I.R.C. § 6662(d), the amount of the understatement under that section is increased by the aggregate amount of reportable transaction understatements as

[24] The AJCA, which added this accuracy-related penalty for reportable transactions, also added I.R.C. § 6707A, a penalty for failing to make timely disclosures required under I.R.C. § 6011 (including failing to disclose listed transactions). See also I.R.S. Notice 2005-11, 2005-1 C.B. 493. Section 6707A applies to returns or statements the due date for which falls after the effective date of the AJCA (October 22, 2004) and which were not filed before that date. As discussed in footnote 3, these Settlement Guidelines will be supplemented if necessary when issues of administering I.R.C. § 6707A become resolved.

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determined by I.R.C. § 6662A(b). I.R.C. § 6662A(e)(1)(A). However, the addition to tax under I.R.C. § 6662(a) applies only to the excess of the amount of the substantial understatement over the aggregate amount of the reportable transaction understatements. I.R.C. § 6662A(e)(1)(B). Thus, I.R.C. § 6662 does not impose a penalty on the amount of the understatement related to the reportable transaction if the Service imposes a penalty under the § 6662A accuracy-related penalty for reportable transactions. See I.R.C. § 6662(b); Gulf Opportunity Zone Act of 2005, § 403(x)(1), Pub. L. No. 109-135.

B. Reasonable Cause for Reportable Transactions

If the taxpayer adequately disclosed the relevant facts affecting the tax treatment at issue, substantial authority for such treatment existed or currently exists, and the taxpayer reasonably believed it was more likely than not that the treatment was proper then the reasonable cause exception can be considered. I.R.C. § 6664(d)(2). The reasonable cause exception for reportable transactions, if the taxpayer satisfies the above three factors, is identical to the reasonable cause exception that applies to the general accuracy-related penalty. See I.R.C. § 6664(c) & (d).

SETTLEMENT GUIDELINES

Issues #1 and #2: The Benefits and Burdens of Ownership and Financing Arrangement Arguments

By applying the facts of SILO transactions to the principles cited in the legal analysis above, it can be argued that a SILO lessor does not (a) have capital at risk[25] or (b) otherwise acquire and retain "significant and genuine attributes" of a traditional owner. Also, as set forth in Notice 2005-13, there are several factors that distinguish the SILO transaction from the Frank Lyon facts: no purposive use of funds, no recourse debt, limits on equity at risk, and the opportunity for profit and risk of loss both limited by options at the end of the leaseback term. Since SILOs contain all the aforementioned distinguishing factors that were absent from the sale-leaseback transactions previously considered by the IRS (through revenue procedures, private letter rulings, etc.) and the courts, it can be argued that the courts should accept Compliance's broader attack on the bona fides of the SILO transactions and loans by viewing all factors in total.

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[25] The Supreme Court found an array of facts and features sufficient to tip the scales in favor of the lessor in Frank Lyon under its "significant and genuine attributes" test. It can be argued that these same facts and features are not present in SILOs.

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Included above is a discussion of seven factors that will distinguish the typical SILO from the sale-leaseback at issue in Frank Lyon.

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On the other hand, the tax-exempt entity's decision whether to exercise the Purchase Option will be influenced by the cost of nonexercise, which includes the cost to the tax-exempt entity of a Service Contract or, in the case of a QTE SILO, RVI and rent for the remainder of the lease term. #

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As indicated above, a traditional sale leaseback usually is a substitute for conventional mortgage financing. In such cases, it can be argued that the transaction is so structured that its economic resemblance to a debt is complete. With SILOs, the seller-lessee obtains a repurchase option that likely will be exercised. Given such, the: (1) seller-lessee is in a position to recapture the property or to enjoy it throughout its life; and (2) seller-lessee's position is more akin to a mortgagor's than a seller's. Consequently, a SILO may be disregarded for tax purposes and treated as a loan of the Equity Collateral by the taxpayer to the tax-exempt entity. Factors that can be used to demonstrate that there is no sale with a SILO include the fact that the owner/lessor: (1) lacks both the risk of depreciation and the benefit of appreciation, see Frank Lyon, 453 U.S. at 580; (2) does not otherwise retain significant and genuine attributes of the traditional lessor status, id. at 584, and (3) does not bear market risk with respect to the property, Kwiat, T.C. Memo. 1992–433 quoting Aderholt Specialty Co., T.C. Memo. 1985-491. Consequently, it can be argued that, in most cases, the: (1) taxpayer acted as a lender in a financing transaction; (2) taxpayer's Equity Collateral should be recharacterized as a loan and that this amount plus accrued but unpaid interest is returned to the taxpayer when the Purchase Option is exercised, or when the tax-exempt entity Service Contract fees; and (3) taxpayer is required to report OID income under §§1271-1275.[35]

[35] As noted above, the Notice and CIP do not include any direct reference to OID or §§ 1271 – 1275, but the OID issue has been formally raised as part of the Government's primary issue.

The Notice and CIP provide that a separate additional adjustment for original issue discount ("OID") income is warranted under the primary financing arrangement argument in accordance with §§ 1271–1275.

Issue #3: The §163 Interest Expense Argument

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Conversely, Compliance argues that whatever profit arises for the taxpayer in a SILO relates solely to the earnings on the Equity Collateral account, not to any present property interest purportedly acquired with the nonrecourse "loans," and that any future property interest the taxpayer may come to possess is wholly contingent on the lessee's failure to exercise its pre-funded Purchase Option.

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Issue #4: Penalties Under §§ 6662 and 6662A

Whether an accuracy-related penalty applies to underpayments attributable to SILO transactions must be determined on a case-by-case basis based upon the application of the legal standard for the penalty (as set forth in the Discussion section above) to the specific facts and circumstances of each case.

Announcement 2002-2, 2002-1 C.B. 304, announced a disclosure initiative to encourage taxpayers to disclose, prior to April 23, 2002, their tax treatment of tax shelters and other items for which the imposition of the accuracy-related penalty may be appropriate. Taxpayers who complied with the provisions will not have penalties asserted under § 6662.

For tax years ending after October 22, 2004, understatements resulting from SILO transactions are subject to the accuracy-related penalty under § 6662A unless the taxpayer qualifies for the reasonable cause exception under § 6664(d).[37]

[37] To be subject to § 6662A, an item must be attributable to a listed transaction or a reportable transaction. As stated in the Discussion section above, SILO transactions were identified as listed transactions on February 11, 2005. Notice 2005-13. In the unlikely event that a return for a tax year ending after October 22, 2004, was filed before that date, § 6662A would still apply to an item on such return attributable to a SILO transaction if the transaction is a reportable transaction. One of the requirements for the reasonable cause exception for reportable transaction understatements under § 6664(d) is that the taxpayer reasonably believed that its treatment of the SILO was more likely than not the proper treatment.

For tax years ending on or before October 22, 2004, the accuracy-related penalty under § 6662A does not apply. For those years, underpayments resulting from SILO transactions will not be subject to the accuracy-related penalty under § 6662 if the taxpayer qualifies for the reasonable cause exception under § 6664(c). If the taxpayer does not qualify for the reasonable cause exception under § 6664(c), then underpayments resulting from substantial understatements of income tax for those years resulting from SILO transactions will be subject to the accuracy-related penalty under § 6662.

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<u>SETTLEMENT POSITION: ISSUES #1, #2 AND #3</u>

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SETTLEMENT POSITION ISSUE #4:

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#	Each case has to be carefully analyzed to determine whether the facts	#
support the application of the accuracy-related penalty.